**EQUITY RESEARCH**

January 8, 2020

**Price:** $190.29  (01/8/2020 )  
**Price Target:** $240.00

**OUTPERFORM (1)**

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**THE COWEN INSIGHT**

As noted in our quick take (here), STZ reported in line EPS in Q3. Best-in-class beer continues to shine, with overall depletion growth of 7.3%, or an even stronger +7.9% for its import beer business. In addition to robust sales trends, healthy pricing fueled beer operating margin growth of 200 bps to 39.3%. STZ remains our Top Pick, and Outperform rated with a $240 PT.

**Best in Class Beer**

STZ’s beer portfolio continues to meaningfully outpace the industry, driven by its premium pricing, which has led to healthy operating leverage and free cash flow generation of $1.5 bn YTD, representing a 23.9% FCF yield on a corporate level. Trends in the core portfolio remain robust, and, encouragingly, the recent deceleration seen in Nielsen-tracked channels was largely attributed to an annual price increase, with the California market cited specifically. In Q3, imported beer depletions grew 7.9%, driven by Modelo Especial, which was up nearly 15%. Notably, beer depletions started the first month of Q4, rising HSDs. Looking ahead, Corona Seltzer’s upcoming launch should supplement the strength in beer, though Modelo remains the largest opportunity as STZ increasingly markets the brand outside of its core Hispanic demographic.

**Wine & Spirits Outlook**

On a difficult comp due to the timing of the Thanksgiving holiday, Power Brands depletions grew 3.3%, while the segment’s overall depletions fell 5.8%. Amid the revised transaction agreement with Gallo, STZ reiterated its expectation for the remaining wine and spirits business to grow sales MSD, with operating margins migrating to 30%, compared to 26.2% in Q3. STZ maintains its focus on prioritizing higher growth, higher margin brands; notably, Power Brands with a retail price point above $11 grew 9% in Q3 in IRI channels.

**Corona Seltzer Ready for Primetime**

Corona Seltzer is set to launch in the beginning of FY21. Seltzer category sales momentum remains robust, with scanner trends for a basket of leading brands up ~275% in the most recent TTW period. STZ sees Corona’s "refreshment DNA" as an opportunity to enable success in the rapidly growing category. As well, STZ anticipates cannibalization to be similar to other recent product introductions, such as Premier, which drove 70-75% incremental sales to the Corona Family. Notably, Corona’s core demographic underindexes to hard seltzer, setting up an opportunistic backdrop. To support the launch, STZ is deploying $40 mm in marketing spend, marking the biggest investment in company history for a new offering.

**Updating Estimates**

Given updated guidance on the asset sale and stronger beer margins, we are increasing our FY20 and FY21 EPS estimates to $9.48 and $9.11, respectively. Please note that our estimates exclude the dilution from the WEED investment (including WEED our FY20 and FY21 EPS estimates are $8.58 and $8.39, respectively). The upcoming launch of Corona Seltzer should further supplement a beer business that remains robust. Our $240 PT implies a FY2 P/E multiple of ~26x. Maintain Outperform.

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Please see pages 4 to 8 of this report for important disclosures.
AT A GLANCE

Our Investment Thesis
We have an Outperform rating on Constellation Brands (STZ). The acquisition of the Crown Imports business was truly transformative for the company and should continue to pay dividends as the company’s EPS growth trajectory has meaningfully changed. We like the company’s outsized exposure to imported beer, a category we expect to continue to take share from domestics. As well, the core wine category continues to improve, reflecting the benefits of SKU rationalization and bolt on M&A.

Forthcoming Catalysts
- Quarterly Earnings.
- Monthly Nielsen Data.
- Corona Hard Seltzer Launch.
- Progress Updates on the Recent Brewery Expansion.

Base Case Assumptions
- HSD growth in beer, DD reported decline in wine & spirits.
- HSD EBIT growth in beer.
- On time completion of brewery expansion.

Upside Scenario
- DD growth in beer, better than expected performance in wine & spirits.
- Continued beer margin expansion
- Faster-than-anticipated completion of brewery expansion.

Company Description
Constellation Brands is the #2 player in U.S. wine and is the category leader in imported beer in the U.S. Having acquired the rights to the Modelo beer portfolio in the U.S., as well as manufacturing assets in 2013, the company’s earnings base has meaningfully transformed, as beer now accounts for more than 75% of STZ’s EBIT. The company’s leading beer brands include Corona Extra, Corona Light, and Modelo Especial. Meanwhile, STZ’s wine portfolio boasts well over 100 brands, with the company’s biggest including Woodbridge by Robert Mondavi, Clos du Bois, and Kim Crawford. The company also has a small share in the U.S. spirits category, via the Svedka vodka brand.

Downside Scenario
- MSD growth in beer, worse than expected performance in wine & spirits.
- Decelerating beer margin expansion, with long-term margins stabilizing in the mid-30’s range.
- Deteriorating wine margins.
- Brewery completion behind schedule.

Price Performance

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<th>Month</th>
<th>Price (01/8/2020)</th>
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<tr>
<td>Apr-19</td>
<td>$240</td>
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<tr>
<td>Jul-19</td>
<td>$220</td>
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<tr>
<td>Oct-19</td>
<td>$200</td>
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<td>Jan-20</td>
<td>$180</td>
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Source: Bloomberg

Analyst Top Picks

<table>
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<tr>
<th>Ticker</th>
<th>Price (01/8/2020)</th>
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<th>Rating</th>
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<td>STZ</td>
<td>$190.29</td>
<td>$240.00</td>
<td>Outperform</td>
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<td>BF/B</td>
<td>$67.14</td>
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<td>SNBL</td>
<td>$2.71</td>
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### Figure 1: STZ Income Statement

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<th>PFCY18E</th>
<th>1Q19A</th>
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<td><strong>GAAP EPS</strong></td>
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<td>$9.07</td>
<td>$2.10</td>
<td>$2.54</td>
<td>$1.96</td>
<td>$1.783</td>
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<td><strong>Dividend</strong></td>
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<td>$0.79</td>
<td>$0.79</td>
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<td>$3.15</td>
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Source: Cowen and Company.
Note: Units in USD. millions.
Note: Fiscal year ending February 2020.
VALUATION METHODOLOGY AND RISKS

Valuation Methodology

Our valuation methodology is primarily based on Price-to-Earnings (P/E), followed by Relative Price-to-Earnings (vs. the S&P 500), Price-to-Sales (P/S) as well as Enterprise Value to EBITDA (EV/EBITDA). In cases where GAAP net income includes large, non-cash items (e.g., restructuring charges), we may use non-GAAP EPS.

Investment Risks

The global beverage industry is subject to a number of potential headwinds. For alcoholic beverages, heightened regulation and taxation are key risks, as is emerging access to legal cannabis. For non-alcoholic beverages, declining consumption, in particular for carbonated soft drinks, represents a key headwind, as do health and wellness concerns around artificial sweeteners. What is more, energy drinks have also come under scrutiny, which has resulted in softer demand, as well as litigation and regulatory risks.

Risks To The Price Target

We rate STZ Outperform. We believe the Crown Imports acquisition has provided a significant benefit for the company’s beer business and bottom line, and we expect market share momentum to build off already strong trends.

Negative Risks: include lower-than-expected growth in beer and flat to declining growth in wine, beer margin below the company’s target, contracting wine margins, and a failure for WEED to stem its operating losses.
STZ
BF/B
SNDL
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Cowen and Company, LLC managed or co-managed a public offering of Constellation Brands in the past 12 months.

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